No. 3009

United States
Circuit Court of Appeals
For the Ninth Circuit

S. G. ARMSTRONG, F. R. CORNISH, M. HAKES, T. A. TRIMBLE, MARY E. TRIMBLE, HOMER TRIMBLE, HARRY TRIMBLE, CORA T. FAVILLE, F. F. FAVILLE, and SCANDINAVIAN AMERICAN BANK of Spokane, a corporation,

Appellants,

vs.

UNION TRUST & SAVINGS BANK, a corporation, as Receiver for Fidelity Lumber Company, a corporation,

Appellee.

Upon Appeal from the United States District Court for the Eastern District of Washington, Northern Division.

Appellant's Brief and Argument

CHARLES P. LUND,
FREDERICK F. FAVILLE,
Solicitors for Appellants.

P. O. Address:
901 Old National Bank Building,
Spokane, Washington.

PETERSON & ROSS - PRINTERS - SPOKANE 3525

No. 3009

United States Circuit Court of Appeals

For the Ninth Circuit

S. G. ARMSTRONG, F. R. CORNISH, M. HAKES, T. A. TRIMBLE, MARY E. TRIMBLE, HOMER TRIMBLE, HARRY TRIMBLE, CORA T. FAVILLE, F. F. FAVILLE, and SCANDINAVIAN AMERICAN BANK of Spokane, a corporation,

Appellants,

vs.

UNION TRUST & SAVINGS BANK, a corporation, as Receiver for Fidelity Lumber Company, a corporation,

Appellee.

Upon Appeal from the United States District Court for the Eastern District of Washington, Northern Division.

Appellant's Brief and Argument

STATEMENT.

The issues involved in this case arise in the following manner:

The Fidelity Lumber Company is a corporation duly organized under the laws of the State of Washington and engaged in the wholesale lumber business.

Said company had issued its bonds which were secured by trust deed on its property and on or about the 7th day of June, 1915, the trustees holding said bonds commenced an action in the District Court of the United States for the Eastern District of Washington, Northern Division, for the purpose of foreclosing the trust deed on said property.

Certain general creditors of said corporation also commenced an action at said time and by agreement of parties and order of court the said two causes were consolidated, in equity.

By order of said court on the 7th day of June, 1915, the defendant herein, the Union Trust & Savings Bank, a corporation, was duly appointed receiver of the said Fidelity Lumber Company with full power and authority to take possession of and preserve all the property and assets of every kind and description belonging to the said Fidelity Lumber Company, to marshal the liens against said property; to ascertain all debts and obligations of said company and in general to perform all of the usual duties of a trustee in chancery.

Claims were filed with the receiver by numerous creditors of the company and the receiver filed a report in said court scheduling all the claims so filed. The appellants herein represent one general class

of claimants. They are each holders of claims against the said Fidelity Lumber Company in the form of written obligations which are designated as "preferred stock certificates," some of which have riders or agreements on the part of the corporation thereto attached. These certificates and riders are substantially in the following form:

> "This certifies that__________________________ is the owner of________shares of the preferred stock of the Fidelity Lumber Company, of the par value of one hundred dollars per share, transferable only on the books of the corporation by the holder hereof in person or by attorney, upon the surrender of this certificate of stock, properly endorsed."

> "The owner of this certificate of stock is entitled to interest on the par value hereof at the rate of seven per cent per annum, payable semi-annually on the first days of July and January of each year. The Fidelity Lumber Co. reserves the right, however, to retire this certificate of stock, or any part thereof, at any time after five years and prior to ten years from date of issuance hereof, by paying the holder hereof the par value of this certificate or such part thereof as is retired, together with accrued interest on the part so retired, and a premium of five per cent thereof, and said company reserves the right to retire this certificate or any part thereof at any time after ten years from date of issuance, by paying the owner thereof the par value of the part so retired, together with accrued interest thereon. This stock is issued pursuant to resolution adopted at a stock-holders' meeting held January 5th, 1909."

> "For value received, the Fidelity Lumber Com-

pany hereby agrees with____________________, owner of preferred certificate of stock No. _________for______shares of the preferred stock of the Fidelity Lumber Company, to redeem said stock at par, with accrued interest, at the end of five years, from the date of said certificate, upon written request of the holder, or his assigns.

Fidelity Lumber Co.,
By A. J. Wilson, Secretary."

Some of the claimants ask for the unpaid interest on these obligations.

The receiver reported to the court on these claims and recommended that all of the same be disallowed. Objections to the report of the said receiver were filed by each of the appellants and upon final hearing the said objections were overruled and the report of the receiver was approved and the claims of these appellants were rejected and disallowed.

This appeal is from the said order of said district court in rejecting and disallowing the said claims of these appellants, and in overruling the objections to the receiver's report.

ERRORS RELIED ON.

The error relied upon in this appeal is that the decree of the district court was erroneous in holding that the appellants herein were not creditors of the Fidelity Lumber Company and entitled to participate as such in the assets of said company, and were not entitled to recover for breach of the contract of the corporation to repay the purchase price of said stock.

BRIEF.

The so-called certificates of preferred stock did not make the holders, stock-holders of the corporation but merely created the relation of debtor and creditor.

> *Heller vs. Nat. Marine Bank,* 89 Md. 602, 73 Am. St. Rep. 212;
> *Elkins vs. Camden etc. Ry. Co.,* 36 N. J. Eq. 233;
> *Westchester etc. R. R. Co. vs. Jackson,* 77 Pa. St. 321;
> *Burt vs. Rattle,* 31 Ohio St. 116;
> *Williams vs. Parker,* 136 Mass. 205;
> *Savannah etc. Co. vs. Silverburg,* 33 S. E. 908 (Ga.);
> *Starrow vs. Texas Cons. etc. Asso'n,* 87 Fed. Rep. 612; 10 *Cyc.* 575.

The contract between appellants and the corporation was no more than a conditional sale. There was one contract for the sale and repurchase of the stock, each object being a consideration for the other. Such a transaction is not prohibited by the statute making it unlawful for a corporation to withdraw or reduce the capital stock.

> *Mulford vs. Torrey Exploration Co.,* 45 Colo. 81, 100 Pac. 596;
> *Vent vs. Duluth C. & S. Co.,* 64 Minn. 307, 67 N. W. 70;
> *Browne vs. St. Paul Plow Works,* 62 Minn. 90, 64 N. W. 66;
> *Porter vs. Plymouth G. M. Co.,* 29 Mont. 347, 74 Pac. 938;

Taylor vs. Miami Exp. Co., 6 Ohio 177;
Williams vs. Savage Mfg. Co., 3 Md. Ch. 418;
City Bank of Columbus vs. Bruce, 17 N. Y. 507;
Ex parte Holmes, 5 Cow. 426;
Bank of San Luis Obispo v. Wickersham, 99 Cal. 655, 34 Pac. 444;
1 *Cook on Corporations,* Sec. 313;
10 *Cyc.* 416.

ARGUMENT.

The question presented by this appeal is whether or not the written instruments as above set forth constitute the valid, legal and binding obligations of the company so that the holders thereof are creditors of the company and entitled to participate in the assets of the company as such, and entitled to recover for the breach of the contract set out.

It is appellants' contention that no matter what name was given to these written obligations, that as a matter of fact the entire contract between the corporation and the claimants created merely the relation of debtor and creditor; that the written obligations were the absolute promises of the corporation to pay the holder thereof a definite amount of money at a definite time with a fixed rate of interest thereon, the latter in no way dependent upon earnings and in no way as a dividend. The holders of the obligations were not entitled to participate in the management of the corporation in any way and no matter what name may have been given to said obligations, they were in fact the mere promises of the corporation to pay a certain amount with interest.

In determining the rights of the parties in an action of this kind there are two things which are

proper to be taken into consideration by the courts: First, what was the contract of the parties as expressed by its terms; and second, what was the intention of the parties in making the contract as shown extrinsically as throwing light upon the interpretation to be placed upon the contract?

It is our contention that these instruments taken together were the mere written obligations of the corporation. As a matter of fact, they were a mere convenient method resorted to by this corporation to borrow money, and these contracts were issued by the corporation for such loans instead of issuing negotiable promissory notes. They are merely the interest-bearing obligations of the corporation and differ little in their legal effect from promissory notes.

There are two classes of claimants holding this preferred stock. One class holds certificates to which a so-called rider or special agreement to repurchase was attached at the time; the other class holds certificates in the same form but without any such agreement to repurchase. The lower court considered the two instruments as one contract, and we shall so discuss them.

The primary question is whether the holders of the written instruments are mere stock-holders of

the company, or whether by the terms of this contract with the company they are creditors thereof and entitled to participate for breach of contract in the distribution of the assets of the company with the other creditors.

It is our contention that by the terms of the contract between the parties the holders of these obligations are creditors of the company the same as the holder of any other interest-bearing bond or other obligation of the corporation.

In many instances the courts have been called upon to determine the legal status of holders of corporation indebtedness that are called "certificates of stock."

Each case must necessarily turn upon its own facts. No two cases are exactly alike, and hence precedents are not as valuable in such a case as they might otherwise be.

The real question for determination is the true interpretation to be placed upon the particular contracts under discussion. Certain general rules, and certain collateral matters, as, for instance, the manner in which the corporation has treated the obligations, are of assistance in determining the proper construction to be placed upon the written instrument.

There are at least three things which we may

take into consideration in determining the proper construction of these contracts. They are:

(1) The language of the instruments themselves.

(2) The resolution of the corporation under which the instruments were issued.

(3) The use to which the company put the instruments and the manner in which the company recognized them.

The so-called "certificate" and the collateral agreement must, of course, be construed together, for they constitute the contract between the parties. They are as follows:

> "This certifies that__________________________
> is the owner of________shares of the preferred stock of the Fidelity Lumber Company, of the par value of one hundred dollars per share, transferable only on the books of the corporation by the holder hereof in person or by attorney, upon the surrender of this certificate of stock properly endorsed.
>
> The owner of this certificate of stock is entitled to interest on the par value hereof at the rate of seven per cent per annum, payable semiannually on the first days of July and January of each year. The Fidelity Lumber Company reserves the right, however, to retire this certificate of stock, or any part thereof, at any time after five years and prior to ten years from date of issuance hereof, by paying the holder hereof the par value of this certificate or such part thereof as is retired, together with accrued interest on the part so retired, and a premium

of five per cent thereof, and said company also reserves the right to retire this certificate or any part thereof at any time after ten years from date of issuance, by paying the owner thereof the par value of the part so retired, together with accrued interest thereon. This stock is issued pursuant to resolution adopted at a stockholders' meeting held January 5th, 1909.

For value received, the Fidelity Lumber Company hereby agrees with________________owner of preferred certificate of stock No.___________ for________shares of the preferred stock of the Fidelity Lumber Company, to redeem said stock at par, with acrued interest, at the end of five years from the date of said certificate, upon written request of the holder or his assigns.

Fidelity Lumber Company,
By A. J. Wilson, Secretary."

In the first place, it is to be noticed that the *name* which the corporation may have given the written instrument is not determinative of its legal character.

Whether these instruments were designated "certificates of stock," "interest-bearing obligations," "guaranteed redeemable obligations," or by some other name, their legal effect must be determined from what they in fact *are*, and not what they are *called*.

In *Heller vs. National Marine Bank,* 89 Md. 602, 73 Am. St. Rep. 212, a case involving the rights of holders of so-called "preferred stock," it is said:

"The mere naming of it does not make it that which it is named, if in fact it is something else. Its properties and qualities determine what it

is. * * * * Calling stock, 'preferred stock,' does not per se define the rights in such stock but these depend on the statute or contract under which it was issued. Elkins vs. Camden etc. Ry. Co., 36 N. J. Eq. 233."

The court further says:

"Courts are not influenced by mere names, they look beyond these and give the subject dealt with, the character, the status which its properties denote it possesses. The qualities and properties of a thing are its essential, they define and mark what it is, the name is purely accidental and is no part of the thing named. * * * * If it possesses characteristics and qualities that are entirely foreign to preferred stock, as strictly defined, and are descriptive of something else, then the thing is obviously either not ordinary preferred stock or not preferred stock at all even though it be called preferred stock, and have in addition to its own qualities some of the characteristics that do pertain to preferred stock."

It is well said in the case of *Burt vs. Rattle*, 31 Ohio St. 116:

"If we can understand the word 'dividend' in the sense of interest, and the word 'stock' in the sense of debt, so that 'certificate of stock' will mean 'certificate of indebtedness' and 'preferred stock-holder' mean 'preferred creditors or preferred certificate holders' there is no trouble in so interpreting the act and making all its provisions harmonious and constitutional."

Again in the cited case it is said:

"The question in such cases is not what did the parties call it, but what do the facts and circumstances require the court to call it."

Applying these rules to the instruments in question, we find that while called "certificates of stock" they are, as a matter of fact, the absolute and unqualified promises of the corporation to pay a certain definite principal sum, at a certain definite and fixed time, and to pay a certain, definite and fixed rate of interest thereon, at certain periods, until the principal becomes due and is paid. While lacking negotiability in the ordinary sense of that term, they meet every other essential of promissory notes in being "unqualified written promises to pay a certain sum in money at a definite time and at a fixed rate of interest."

One very essential and striking characteristic which of itself distinguishes these instruments from certificates of stock is that they provide for the payment of *interest* on the face of these certificates at the rate of 7 per cent per annum, payable semi-annually. This alone makes these certificates unique and peculiar and distinguishes them essentially from the common run of preferred stock certificates. It is to be noted that the certificate makes no provision about the payment of *"dividends"* or about any preference to the extent of 7 per cent in "dividends." The certificates do *not* provide that the holder is to have a preference over other stock-holders in the *"earnings"* of the corporation. Nothing of the kind

can be claimed for the language used, for it clearly and unmistakably declares that "this instrument bears *interest* at 7 per cent per annum, payable semi-annually." If the corporation did not earn one dollar this interest would still be due and payable. It has no relation whatever to the earnings, profits or dividends. It is intentionally designated as "interest."

It will be observed that it is not as some of the cases where a certain per cent is to be paid "if earned" or "out of dividends" or "from earnings" or "out of profits." It is an absolute, unconditional promise to pay as *"interest"* a certain per cent.

If this were an ordinary certificate of stock we take it that it would be void as against public policy for the corporation to provide by contract with its stock-holders, as stock-holders, that they should receive a fixed and definite amount whether there were any earnings out of which the same could be paid or not.

It is one thing for a corporation to agree with its *creditors* that it will give its written obligations to pay interest on a certain sum at a fixed rate, but it is a different thing for the corporation to agree with its *stock-holders* that it will declare and pay them dividends to a certain amount whether the same are earned or not.

If this was stock in the ordinary use of the term then the contract was illegal on the face of it as requiring the corporation to pay on stock a certain dividend whether any dividend at all was earned or not.

On the other hand, if this contract is construed as we contend it should be, then it is perfectly legitimate and binding on the corporation. It is merely a method adopted by this company to borrow money and agree to pay to the lender a certain fixed interest thereon, and it was wholly immaterial to the creditor whether the company acquired any profits or could declare any dividends.

The holder of this obligation was entitled to his interest, as interest, whether the company was prosperous or not and utterly regardless of whether there were any profits or earnings to be divided.

It therefore follows that the first primary and essential characteristic of stock is utterly wanting in these instruments, while on the contrary they are the legal and valid interest-bearing obligations of the corporation.

In *Westchester etc. Ry. Co. vs. Jackson, 77* Pa. St. 321, the statute under which the stock was issued provided that the holders thereof would be entitled to receive a "dividend" of 8 per cent per annum upon stock, payable semi-annually. The court held:

> "The payment for his shares by Mr. Gray and the issuing of certificates to him by the defendant made as complete a contract as if he had been the purchaser of bonds instead of a subscriber for stock. * * * * A corporation may issue new shares and give them a preference as a mode of borrowing money, where it has power to borrow on bonds and mortgages, as preferred stock is only a form of mortgage."

Attention is also called to the fact that the so-called preferred stock was not intended to form a permanent part of the capital of the corporation, for provisions were made for its redemption, exactly as in the case at bar, and the court held that the holder of this so-called preferred stock was a creditor of the company.

It seems to us that this case is strikingly analagous to the situation in the case at bar. True, in that case the certificate provided for a "dividend" which the court construed to be interest, and exactly as in the case at bar the court held that the scheme of the corporation was merely a mode of borrowing money and that the issuance of the so-called certificates of preferred stock was only a form of mortgage.

Exactly as in the case at bar provision was made for the final redemption by the corporation of the certificates at their face value, and so, in the case at bar, the corporation expressly agreed "to redeem said stock at par with accrued interest at the end of five

years from the date of said certificate upon written request of the holder or his assigns." Therefore we have an interest-bearing written obligation providing for the payment of interest, as interest, whether earned or not, and providing absolutely that the company may pay the principal in full at its option at any time after five years, and that at the request of the holder it must pay the principal with accrued interest at the end of five years. What other or different is this than a written obligation of the corporation bearing interest and payable at a certain date?

In *Williams vs. Parker,* 136 Mass. 205, the stock contained a guarantee that the holder should receive "semi-annual dividends" of a *fixed* amount. The court held that this provision for semi-annual dividends was in legal effect an absolute promise to pay this amount semi-annually whether there were dividends out of which it could be declared and paid or not, and held that if it became necessary, the holder of this certificate could require the payment of this semi-annual amount in effect as interest out of the property of the company. So in the case at bar, it seems to us no one can question that the holder of these certificates, at any interest paying date, could have maintained an action against the company for the interest then due, and it would have

been no defense whatever to such an action that the company had not earned any dividends out of which to pay said interest. If this promise of the company could have been so enforced then it seems to us that the conclusion is inevitable that the contract was a debt, compelling and requiring the company to pay its obligations utterly regardless of whether it was earning any profits. If this be true, then the instrument is not stock, and no matter what it is called, it is nothing more than the enforceable obligation of the company, or, in other words, nothing more nor less than evidence of a debt.

In the case of *Burt vs. Rattle,* 31 Ohio St. 116, there is a very similar state of facts to the case at bar. In that case the certificate provided that the company would guarantee semi-annual dividends at a rate of 4 per cent per annum and guaranteed the final payment of the face value of the obligation on a certain date. The obligation was described and designated as "preferred stock." The case is practically on all fours with the case at bar, with the exception that "dividends" were to be paid, while in the case at bar the company was to pay "interest." So that the instant case is a stronger one on the theory of the certificate being the debt of the corporation, than is the cited case. The Ohio court refers to the holders of these certificates, saying:

> "They have no right to vote or to take any part in the possession or control of the concern. They gain nothing by its success and lose nothing by its failure. They have no participation in either its profits or losses. * * * * A man who advances his money to a corporation and takes a bond and mortgage for its re-payment and who by express agreement between the parties takes no risk or interest in the concerns of the company, is a creditor of the company, and to call him a stock-holder is a simple misnomer. He is a creditor and remains a creditor until by some future act of his own he elects to become a stock-holder or otherwise changes his relation. The right to become a stock-holder does not make the possessor a stock-holder."

This is especially true of the instant case. The holders of these certificates had no right to vote or to take any part in the possession or control of the concern. They gained nothing whatever by its success and lost nothing by its failure. They were entitled to their interest, no more and no less. Whether the company was prosperous or operated at a loss was wholly immaterial to them. They got their 7 per cent interest semi-annually in *any* event. As the Ohio court says, they took no risk or interest in the concerns of the company, and simply were entitled to draw interest on the principal of the obligation when the same became due, and such a party is a creditor of the company and to call him a stockholder is a simple misnomer."

Again, the case of *Savannah etc. Co. vs. Silverberg,*

33 S. E. Rep. 908, is so very closely in point as to the facts and the issues involved that we especially call the court's attention to it.

The certificates were almost identical in form with those in the case at bar. They provided that the holder should receive a "dividend" of 8 per cent per annum. The holder was denied the right to take part in stock-holders' meetings and the contract provided that the stock should be retired at a certain date. In every essential particular the stock was of the same kind as that in the case at bar. The court held that the resolution authorizing the issuing of the stock should be taken into consideration with the certificate in determining the construction to be placed upon it. The court discusses the various propositions as to the withholding of the right to vote, the use of the word "dividend," the fact that the issue was to be retired, and the other matters shown in the certificate. In every essential the case is identical with the case at bar, and the court concludes:

> "Looking at the substance of the contract now under investigation, our final conclusion is that the relation of lender and borrower arose between the parties and that the paper issued at the time the money was advanced, although in its form it appears to be a certificate of stock, is, in fact and in substance, simply an evidence of indebtedness which the holder has a right to enforce against the person executing it."

It will be noticed that in the cited case the certificate provided that the holder should receive a "dividend," and again we call the court's attention to the fact that there is no reference whatever to a dividend in the case at bar. These certificates provide for *interest* and nothing else. In the cited case provision was also made that the stock should be retired at a certain date, exactly as in the case at bar. As the Georgia court declared, it is essential to look at the substance of the contract and not merely at the designation that is given the instrument, and that as a matter of fact the so-called certificate is simply an evidence of indebtedness, bearing a fixed rate of interest and requiring unconditionally its absolute payment on a certain fixed date.

The case of *Starrow vs. Texas Cons. Compress & Mfg. Asson'*, 87 Fed. Rep. 612, involves a discussion of the question of preferred stock. In this case the certificates provided for a guaranteed dividend of 6 per cent "to be paid only out of the net earnings of said association." It will be observed at once that this very materially differs from the certificate in the case at bar because it provides not for the payment of a certain definite amount as interest in any event, but expressly provides that the dividend is to be paid only out of net earnings. In discussing the case the court says (page 616):

> "The preferred stock-holder has no vote or voice in the management of the corporation. He possessed none of the rights of a common stockholder as such, and about the only difference between him and the ordinary lender of money was that he was not to receive his interest unless there were sufficient net profits to pay the same. Therefore so far as the face value of the preferred stock is concerned, it is in the nature of a debt against the corporation and the interest thereon becomes a debt as soon as it can be shown that there were profits wherewith to pay it, and becomes a lien prior to the rights of the holders of common stock upon the net earnings if there were such, for the amount of the dividend, and can be followed wherever invested by the company."

Now applying this rule to the facts in the case at bar, it seems to us there can be no escape from the proposition that the holders of these certificates of preferred stock were creditors of the company and were in effect mere "ordinary lenders of money."

In the cited case it is held that they would be such creditors if they were to receive interest in *any* event regardless of net profits. That is precisely the contention we are making in the instant case. The certificates of stock on their face do not call for the payment of a dividend or interest "*if* the same was earned," but as we have heretofore pointed out, require the company to pay a definite amount of interest, as interest, utterly regardless of earnings. The rule recognized in the cited case is especially applica-

ble to the case at bar and the reasoning therein, it seems to us, is conclusive on the proposition that under the terms of the contract in the instant case, the relation of debtor and creditor was created by these certificates.

We can see no good reason why the holdings of these courts should not be followed in the instant case.

Undoubtedly in the great majority of instances where preferred stock is issued the holder thereof is a stock-holder and not a creditor. Many instances have arisen in which the question has been discussed regarding the rights of the holders of such stock as against the holders of common stock. Such cases can be of no assistance in the determination of the proposition involved in this case.

Each case must be decided according to its own facts and the authorities we have cited show the holdings of the courts in cases so nearly analagous to the case at bar as to be most persuasive in the determination of this question.

II.

But we are not limited in determining this matter merely to the language of the written instruments. As we have heretofore demonstrated, in and of them-

selves these instruments on their face show that they create the relation of debtor and creditor and not the relation of a stock-holder to the corporation.

Our position in this regard is enforced and corroborated by the resolution adopted by the corporation authorizing the issuance of this so-called stock, or, in other words, creating the loan.

The resolution not only authorizes the issuance of the written instruments in the form set forth above but provides that the company should *"guarantee"* the payment of the interest thereon. This is conceded in the stipulated facts in this case. (Transcript page 41.)

So that the corporation in authorizing this loan and the issuance of these evidences of debt made no mistake as to what it was doing. It did not intend to issue stock that should have a preference in dividends or earnings, but it provided for the issuance of these obligations and that it should "guarantee" a payment of interest at the rate of seven per cent per annum thereon.

So that the company advisedly provided for the issuance of these written instruments guaranteeing the payment of interest regardless of earnings and expressly providing for the repayment of the loan at a certain date.

Under such a situation it is well said in 10 Cyc. 575:

> "The sound view plainly is that where the corporation guarantees, as is sometimes the case, not only interest on the stock, but also agrees to receive back or otherwise liquidate the principal of the shares at par, at a date named, then the certificates become substantially an interest-bearing bond of the corporation and the holder of it becomes to *the fullest extent a creditor,* although he may also have rights pertaining to a shareholder, such as the right to vote at corporate meetings. It has been pointed out that under some schemes what has been called 'preferred stock' is really an interest-bearing debenture of the corporation, which creates the relation of debtor and creditor between the corporation and the so-called share-holder."

This clearly is a "sound view" and is one that "plainly" applies to the case at bar. We come under the precise situation described in the text quoted. In the instant case the corporation "guarantees not only its stock but also agrees to receive back or otherwise liquidate the principal of the shares at par, at a date named," and as is said in the text, under such circumstances *"the holder becomes to the fullest extent a creditor."* Such an obligation creates the relation of debtor and creditor "to the fullest extent."

Numerous cases can be found holding to the general proposition that "a holder of preferred stock is not a creditor of a corporation." Generally and broadly speaking, that is true, and we are not disputing such a proposition. But the important and distinguishing point we are urging is, that by the terms of *this* contract, the claimants were not pre-

ferred stock-holders at all. The whole matter of distinction in the cases turns upon the construction of the *particular* contract. If by the contract the relation of debtor and creditor was created, then we have the rights of a creditor, and can not, and should not be deprived of these rights, under a general rule that ordinarily the holder of preferred stock is not a creditor. But we have yet to find the case holding that where a corporation issues its written obligations bearing a fixed rate of interest which it "guarantees" to pay, utterly regardless of earnings or dividends, and expressly agreeing to repay the face of the obligation on a certain date, that the holder of such an obligation is not a creditor.

The case of *Spencer vs. Smith,* 201 Fed. Rep. 647, referred to in the opinion of the learned District Judge and which no doubt will be relied upon by counsel for appellee, does not controvert our position in the least. The court announces the general proposition that holders of preferred stock are not corporate creditors. We concede this proposition. It is held that the certificates in that case made the holders thereof stock-holders and not creditors, but there is a very clear distinction between the instruments in that case and the ones in the case at bar. In that case the instruments possessed the most essential and pronounced characteristics of stock, namely,

that they were "entitled to cumulative *dividends* of ten (10) per cent per annum payable quarterly, commencing April 1st, 1906, *from the net profits* of the corporation *before any dividends are paid on the common stock,* and the common stock is entitled to all dividends in excess of said ten (10) per cent." Who would claim that this created the relation of debtor and creditor? The holder was to participate in *dividends* if dividends happened to be earned. But in our case the corporation bound itself to pay *interest as interest,* whether anything was earned or not. This one thing makes the cases clearly and plainly distinguishable.

In the one case, the holder, like every other stockholder, was merely to be preferred to a certain extent in dividends if dividends were earned. Like any other stock-holder he had to await the earning of dividends before anything was due him. In our case, however, the relation of debtor and creditor was absolutely fixed from the very start. If the corporation had not paid the interest it agreed to pay when an installment became due, an action could have been maintained *at once* to recover it. Would it have been any defense that no *dividend* had been earned out of which to pay it? By no means.

In the Spencer case, however, no action could have

been maintained except for participation as a stockholder in properly earned dividends. In the Spencer case the contract as construed by the court provided "if thereafter the corporation made profits, the holder of any preferred stock would receive dividends; and, if at any time the corporation was dissolved and its assets were distributed, the preferred stock would be preferred as against the common stock."

Undoubtedly this made the holder merely a holder of preferred stock and not a creditor. But how different is the situation in the case at bar, when the relation of debtor and creditor was created the instant the instruments were issued under a guarantee to pay seven per cent interest in *any* event.

Furthermore, it is to be noted that while this instrument declares that the holder owns "shares of the preferred stock of the Fidelity Lumber Company," it *nowhere,* by express statement or even intimation suggests, wherein, how, over whom, or what, it has any preference. It makes *no* reference to the common stock. It does not say, as in the great number of cases, including the Spencer case, that it is to be preferred by being entitled to dividends from the net profits "before any dividends are paid to the common stock." If it did, *then* it would of course be preferred stock,—a stock with a preference over other stock, in dividends *if* dividends were earned.

In the instant case it is of no little significance that a so-called "preferred stock," by no contract, resolution or otherwise, makes any preference whatever to the thing over which it is to be preferred or the manner in which that so-called "preference" is to be secured.

As has been well said: "Calling such a contract as this 'preferred stock' is a mere misnomer."

As well might the corporation have denominated it a dozen different things as to have called it "preferred stock" and then created no preference over anybody or anything by the contract.

It did nothing more nor less than issue its paper due in five years and bearing seven per cent interest and call it "preferred stock" instead of calling it by its true name.

If any case can be found holding that a contract with terms of this kind, either in language or legal effect, makes the holder a stock-holder and not a creditor of the corporation, we must confess we have been unable to discover it. We do not believe any such case can be found.

III.

Again, in considering and determining the true interpretation to be placed upon the contract in ques-

tion we should take into consideration the manner in which the parties themselves treated it.

If this contract was a mere certificate of preferred stock and is ambiguous in not disclosing wherein the preference lies or over whom the holder has a preference, we ought to get some light on this question by ascertaining how the parties themselves treated it.

For example, if the company made profits and declared dividends and the holders of this stock were given a preference in these dividends and received and accepted the same, it would furnish us very valuable data from which to determine the true character of the contract as intended and as construed by the parties themselves.

But let us see what in fact happened. * * * There is no pretense that this company ever declared any dividends in any way, shape, manner or form, and there is no claim that the holders of these certificates participated in any such dividends to the extent of 7 per cent or any other amount.

On the contrary, it affirmatively appears from the agreed facts in the record (Transcript page 44) *"that as to a large amount of this preferred stock, interest was in fact paid at the rate specified in that certificate and at the time fixed in the certificate, and without reference to the fact as to whether the company*

had earned dividends out of which the same could be paid and was in fact so paid." In other words, this company and the holders of these certificates treated this obligation as being exactly the thing it was, namely, the interest-bearing indebtedness of the corporation, and at the time fixed in the certificate, to-wit: twice a year, without any reference whatever as to whether the corporation had earned any dividends at all or not, this interest was paid. Why was it paid? Because a stock-holder was having preference over other stock-holders in a dividend which had been earned or declared? By no means. It was being paid *as interest* because the company had borrowed this money from the holder of this paper, and had agreed to pay him interest on it, and because the *interest* was then due. If he was a stock-holder could he have demanded such payment?

It seems to us that it is exceedingly significant that from the time of the issuance of these certificates and while this company was a going concern, without any claim whatever that it earned a dollar of dividends, or that these so-called stock-holders had a preference in dividends over other stock-holders, the company continued to pay the interest which these contracts called for seasonably.

Certainly the parties themselves, both the corporation and the stock-holders, understood and construed

this contract as creating the relation of debtor and creditor from its inception and throughout acted in accordance with such understanding.

Can it now be said that the receiver of this company is in a position to ask the court to construe this contract other and different than its own terms plainly provide, and as the parties themselves have construed it and acted upon it during a long period of time? It is elementary law, requiring no citation of authorities, that where a contract is doubtful it will be construed by the court where possible in the manner in which the parties to it have acted upon and construed it.

That is exactly what we are asking the court to do in this case, and the agreement which the parties themselves made and which they carried out in good faith on both sides and construed and acted upon, without doubt or question while the company was in existence, should, we submit, be fulfilled and carried out by the court under the existing condition.

Another significant thing that we call the court's attention to in regard to this so-called stock is that the corporation not only issued it for money actually turned over to the company, but actually used it to pay for property purchased by the corporation. The corporation bought certain timber claims and paid

therefor part in cash and part in these certificates of stock with the agreement attached to "redeem" the same at a certain time and pay interest at a certain rate in the meantime. The corporation paid the interest at the times stated regularly, without reference to the earnings of the company, and finally issued its promissory note, running for ninety days more time, in payment of the original obligation evidenced by the certificate of stock.

What more significant fact could there be as to how the parties understood and treated the contract? The corporation used these certificates exactly the same as their promissory notes and issued them in payment of property which it purchased. After keeping up the interest, when the obligation became due according to its terms, the corporation took up this paper and got a ninety days' extension and issued its note for the debt. (Transcript pages 48, 49 and 111.)

What clearer evidence could there be of how the parties construed and understood the contract than this transaction?

Corporations do not thus deal with preferred stock. But the transaction was a proper and legitimate one in the purchase of property and the issuance of an interest-bearing obligation therefor.

Again, as fortifying our position, we call the court's attention to the fact that not only did the corporation pay the interest on these certificates in most intsances as it became due, but carried out the collateral contract and paid off the obligations as they matured.

It is stipulated of record (Transcript page 44) "that of the issue of stock (referring to these certificates) about $60,000 was in fact paid for in full by the company with the interest on it."

This is of vast significance in helping us to determine the intention of the parties and the manner in which they construed this contract. Not only in issuing them and in paying interest on them but as well in paying them off at maturity, did the corporation treat these obligations as being nothing other or different than debts of the corporation. It appears that before the receiver was appointed the holders of $60,000 of these certificates had been paid as the collateral contracts provided. We are only asking that as to these remaining creditors the same contract be carried out. That these claimants were less fortunate than others in not getting their money does not deprive them of the right under their contracts to now receive the amounts due them. Until the receiver was appointed the corporation never hinted at any claim that these certificates were not the debts of the corporation. The corporation was issuing

them for borrowed money and in payment of property purchased. It was paying the interest thereon as it became due. It was to a very great extent paying off these obligations as they matured. No one had any thought that the contract was other or different than its terms expressed and as the parties treated it. We are merely asking the court to construe the agreement as the parties themselves construed it, and to direct the receiver to act as the corporation itself acted on these obligations. It is both legal and equitable that these claimants should be placed in the same position as other creditors holding similar obligations have been placed.

IV.

It was the view of the trial court that the agreement on the part of the corporation to repay the amount received by it for these certificates was illegal and void. Even if so, the certificates without such agreement are merely debts. The theory is that if these certificates are nothing but certificates of stock in the capital stock of the corporation, that then an agreement by the corporation to repurchase the same would be illegal under the statutes of the State of Washington. We do not admit that such a result would necessarily follow under such circumstances under the laws of that State, but let us, for the sake

of argument only, admit for the moment that such result would follow. If it be true, as a matter of law, that such a result would follow, then we contend this fact, of itself, sustains our claim as to the construction that should be placed upon the contracts. It certainly is not to be presumed that the corporation undertook to do an illegal thing. If there is doubt in the matter, the courts will construe the contract as legal rather than illegal, if it is capable of such construction. This is hornbook law. If to call these obligations "stock" makes the contract illegal, then the corporation has committed a "legal fraud" upon these claimants, for it has taken their money under a promise to repay it, which promise it is now said is void, simply and solely because the obligations are "stock." If, on the other hand, these obligations are contracts or debts of the corporation, then they are perfectly legal and the corporation had a perfect right to enter into them and carry them out. Presumptions are to be indulged in favor of the legality of the transaction. If doubtful, the contract is to be construed as valid and not as illegal and void. The fact that these claimants will be deprived of their right to recover on a contract under which the other party has received the full benefit, should of itself cause the court to construe the instruments as legal if they are capable of such construction.

So that we submit if it be true that the contention of the receiver results in construing these instruments as non-enforceable, that very fact should cause the court to place upon them that construction, if possible, which would uphold them, and carry out the intent of the parties.

The question of the alleged illegality of the contracts was not placed in issue by the receiver either in his report as the ground for disallowance of appellants' claims, or otherwise. We think that there should have been such an issue tendered if it is to be urged.

However, as we have suggested above, the fact that such a claim is or can be made, in and of itself sustains our contention is to the manner in which the contracts should be construed.

Again, we respectfully urge upon the court that even if the statutes of the State of Washington (Transcript page 63) provide that it shall be unlawful for the trustees of a corporation to in any way pay stock-holders any part of the capital stock of the corporation or reduce the capital stock of the company except in the manner provided by law, that still under the undisputed facts in this case, the statute would have no application whatever in this case, and could not be urged by the receiver to defeat the rights of these claimants.

In connection with this proposition we desire to call the court's attention to the case of *Mulford vs. Torrey Exploration Co.,* 45 Colo. 81, 100 Pac. Rep. 596. This is a very well considered case and the argument therein is especially applicable to the situation in the case at bar. It sustains our contention fully and supports our position by reasoning and precedents.

In that case the plaintiff sued to recover on a contract by which the corporation agreed with him to repurchase certain shares of stock from the plaintiff. It appears that the contract for repurchase, exactly as in the case at bar, was executed contemporaneously with the issuance of the stock. There was no question in the cited case but that the instruments held by the plaintiff were certificates of stock in the corporation, and exactly as in the case at bar, the question arose on the breach of the contract made with the corporation at the time to redeem and pay for this stock. The statute of the State of Colorado on this subject is even stronger than the statute of the State of Washington. It is clear and concise and is quoted in the cited case. The Supreme Court of Colorado said, referring to this matter:

> "The statute upon which the defense is based, to the effect that the contract in question are in violation of the statutes of the state, is as follows: 'It shall not be lawful for such corpora-

> tions to use any of their funds for the purchase of stock in their own company or corporation, except such as may be forfeited for the non-payment of assessments thereon, except as hereinafter provided.' Section 485, 1 Mills' Ann. St. This statute does not apply. The company desired to sell its treasury stock. It received the consideration agreed upon therefor. The plaintiff only purchased upon the condition that he should have the right to return the stock, and have the consideration which he gave therefor returned to him. There was but one contract, namely, for the sale and repurchase of the stock; each object being a consideration for the other. The sale was therefore conditional. Such a transaction is not prohibited by the statute. If, however, it could be successfully contended that the contracts in question are *ultra vires,* then the defendant can not escape liability thereon for the reason that, where a corporation reaps and retains the fruits of an act which is merely unauthorized, it will not be permitted to interpose the defense of *ultra vires.*"

This, it seems to us, is conclusive on the proposition involved in the instant case. The statute referred to does not apply to such a situation at all. Exactly as in the cited case the company desired to sell its stock (assuming that the instruments herein are certificates of stock). These appellants only purchased upon the condition that they should have the right to return the stock and have the consideration which they gave therefor returned to them. There was but one contract, namely, for the sale and repurchase of stock; each object being consideration for

the other. The sale was therefore conditional and not prohibited by the statute.

If, however, it could be successfully contended that such a contract was *ultra vires,* then the corporation can *not* escape liability for the reason that where a corporation reaps and retains the fruits of an act which is merely unauthorized, it will not be permitted to interpose the defense of *ultra vires.*

In this discussion we are assuming for the sake of argument only, that this issue is properly before the court and that the claimants are "stock-holders," and even if so, we most respectfully urge that under well recognized rules of law, such a contract as was made with these appellants in the instant case was perfectly valid and enforceable. If this was stock that was sold, it was sold under a written agreement as a part of the consideration made at the time of its issuance, that the corporation would take the stock back and repay the purchase price if demanded by the holder. The stock was properly tendered back and repayment demanded. (Transcript page 92.)

Under the authorities universally recognized, and which we believe can in no respect be disputed, such a transaction *is perfectly valid and the corporation can not accept the money and then repudiate its portion of the contract under the claim of ultra vires.*

And certainly if the corporation itself can not repudiate the contract, the receiver can not do so.

The cases cited by the Supreme Court in the *Mulford* case fully sustain the position we take.

In *Vent vs. Duluth C. & S. Co.*, 64 Minn. 307, 67 N. W. 70, the Supreme Court of the State of Minnesota, in conisdering such a contract for the repurchase of stock which was claimed to be *ultra vires,* said:

> "This provision of the contract constituted a material and substantial part of the consideration and inducement for the purchase of stock by plaintiff and if the purchase is void it seems to us that it vitiates the whole contract and is a sufficient reason for the recission of that contract and the return of the purchase price, which purchase price plaintiffs are demanding. But the better opinion, it seems to us, is, that which holds the original contract to be a conditional sale with the option to revoke and rescind in the purchaser."

It will be noticed in the case at bar that the agreement for the repurchase of the stock provides that it is to be "upon the written request of the holder or his assigns." (Transcript page 62.) Therefore, it was "a conditional sale with the *option* to revoke or rescind in the purchaser."

The case of *Porter vs. Plymouth Gold Mining Company,* 29 Mont. 347, 74 Pac. 938, is a very well considered case and covers the proposition involved in

the case at bar. In that case a contract was entered into between the plaintiff and the corporation whereby the corporation agreed to sell to the plaintiff certain shares of its corporate stock for an agreed price and agreed to repurchase the same at the expiration of six months, if the plaintiff so desired. The court held that there was but one contract, namely, for the sale and repurchase of the stock, each object being the consideration for the other. The court said:

> "This contract was entire and indivisible. The sale could not be sustained unless the contract of repurchase could be enforced. Therefore, if a portion of the contract is *ultra vires,* the *whole contract* must fall. The corporation can not be heard to say that the sale was valid and the contract to repurchase was void without rescinding the sale and returning the purchase money, thus placing the other party in statu quo ante. The appellants have executed the contract of purchase on their part by the payment of the purchase price. The corporation therefore has received from them something of value, which it would not have received except for its contract of repurchase. It can not be heard to say: 'True, I have received your two thousand dollars, which I promised to return to you upon the happening of certain events, but my promise in that regard was and is beyond my power to enter into, and, although the contemplated events have occurred, I will keep your money and will not perform my contract.' Such action, if allowed, would be reproach upon the law. It is not honest or right, and right is the basic principle of all law."

It was claimed in that case that the statutes of the State of Montana, as is here claimed for the statutes of the State of Washington, prohibited the reduction of the capital stock of the corporation except in a certain manner. The effect of the two statutes appears to be idetnical.

Commenting on this question, the Supreme Court of Montana said:

> "Would the capital stock of the company have been reduced in violation of Section 438 of the Civil Code by the purchase of this stock? Section 438 of the Civil Code provides as follows: 'Directors of corporations must not * * * * reduce or increase the capital stock except as hereinafter specially provided.' The mere repurchase of this stock would not tend to decrease the capital stock of the company unless the directors should absolutely merge or extinguish the stock after its repurchase. The company could own and deal with it just the same as it had done before the sale. It could be sold and issued again. The company would be in no different position as to this stock than it would have been had the transaction with appellants in regard to it never occurred. When it is transferred to the company, it becomes a part of its property. It is there for the creditors and stockholders. The capital stock is not decreased. A portion of the capital of the company may be unavailable until the stock is again sold and issued, but nothing is destroyed. Whether the stock is merged or extinguished or held as an asset for sale is much a matter of intention on the part of the corporation. If it is unlawful to decrease the capital stock, presumptively the directors did not violate the law. It would re-

> quire some positive showing to the contrary to overturn this presumption. The following authorities lend sufficient support to this position: 1 Cook on Corporations, Sec. 313; Taylor v. Miami Exp. Co., 6 Ohio 177; City Bank of Columbus v. Bruce, 17 N. Y. 507; Williams v. Savage Mfg. Co., 3 Md. Ch. 418; Ex-parte Holmes, 5 Cow. 426; State v. Smith, 48 Ct. 266; Morgan v. Lewis, 36 Ohio St. 1, 17 N. E. 558; Bank of San Luis Obispo v. Wickersham, 99 Cal. 655, 34 Pac. 444."

It seems to us that the argument in this case is absolutely in point in the instant case and that it is unanswerable. The statute of the State of Washington does not prohibit such a contract as the corporation entered into in the instant case. As is so plainly said by the Supreme Court of Montana, "the mere repurchase of the stock would not tend to decrease the capital stock of the company, unless the directors should absolutely merge or extinguish the stock after its repurchase." "The company would be in no different position as to this stock than it would have been had the trasaction with appellants in regard to it never occurred." "When it is transferred to the company it becomes a part of its property. It is there for the creditors and stock-holders.". "Whether the stock is merged or extinguished or held as an asset for sale is much a matter of intention on the part of the corporation. *If it is unlawful to decrease the capital stock, presumptively the directors*

did not violate the law. It would require some positive showing to the contrary to overcome this presumption." It seems to us that comment can not add to the clear announcements of the court in dealing with a situation identical with that in the case at bar, under a statute of the same import. The reasoning is conclusive. This statute of Washington does not in any way prevent the carrying out of this contract.

We therefore submit to the court that the action of the trial court in denying the claims of these appellants should be reversed, and that a mandate should issue requiring the receiver to pay the several claims of these appellants based on said certificates of stock.

Respectfuly submitted,

CHARLES P. LUND,

FREDERICK F. FAVILLE,

Solicitors for Appellants.

P. O. Address:

901 Old National Bank Building,

Spokane, Washington.